FOR ARGUMENT

Supreme Court, U. S.
FILED
OCT 21 1977
MICHAEL RODAK, JR., CLERK

No. 76-624

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

FRANK LYON COMPANY, *Petitioner*
v.
THE UNITED STATES, *Respondent*

On a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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SUPPLEMENTAL MEMORANDUM FOR THE PETITIONER

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In a supplemental memorandum, the Government has set forth a recent Third Circuit case, *Sun Oil Co.* v. *Commissioner*, No. 76-2388 (September 7, 1977). In this responding memorandum, the petitioner will undertake to show the fundamental differences between that case and this, and the reasons why the decision of the court in the *Sun Oil* case should not affect the decision here.

I

The *Sun Oil* case is a two-party case, like *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939). See Pet. Reply Br. 1-6. In *Sun Oil*, the tax-exempt pension trust lender, having large cash assets to invest, put up money, and did nothing else. It took no risk, it merely held the property as security for its claims, as did the bank in *Lazarus*.

The property involved in *Sun Oil* was "mostly unimproved" land (Supp. Mem. 4a), and thus essentially not subject to depreciation. Rentals were sufficient to amortize the investment of the trust in full over the twenty-five year term, with an interest rate which was low because of the tax-exempt status of the lessor-lender.[1] Renewal options were at low levels, bearing no relation to the fair market value of the land at the time of renewal. Most important, Sunray retained the prerogative of ending the lease on any site by making a "rejectable offer" to purchase the property at an amount equal to the present value of the rents plus enough to insure the trust a 5% return.[2] Supp. Mem. App. 7a. Such offers could be made at will if Sunray were going to discontinue the business use of the property, or on specific dates if Sunray merely determined that continued leasing was "unprofitable or unreasonable or unnecessary" in its sole judgment. In lieu of

[1] The agreed interest rate on the first block of 120 parcels was 4⅝% and the rate on the second block of 200 parcels was 5⅜%. Supp. Mem. App. 5a.

[2] If the "rejectable offer" was accepted, Sunray would buy the property at this agreed price. If it was rejected, the trust would remain the owner, and "Sunray would be released from its obligation to lease the property which it had offered to purchase." Supp. Mem. App. 7a-8a.

making a rejectable offer, Sunray had the power to substitute for the leased premises other land of equal value to be determined by Sunray's book value.

Sun Oil had made over 130 rejectable offers, all of which were accepted by the trust.

The court concluded, as this Court did in *Lazarus*, that the sales and leases back were financing arrangements, similar to mortgages, and thus that Sunray's "rental payments" were not deductible as such, though, of course, the interest element in them would be deductible.

II

The present case is a three-party case. Frank Lyon Co. was not a financing organization. It was an entrepreneur. New York Life provided the permanent financing, and like the trust in *Sun Oil*, was guaranteed full return of its money plus agreed interest over the twenty-five year primary lease term. Worthen Bank, the lessee, however, undertook no obligation to see that Lyon came out whole. At the end of the initial term of the Worthen bank lease, Frank Lyon Co. will have paid off the loan made to it by New York Life, but it will not have recovered its original cash investment of $500,000, and it will have paid out in taxes on building rentals an additional net amount of approximately $436,000. See P. Ex. 36 at App. 595. In terms of net cash position, Frank Lyon will still have nearly a million dollars invested in the building when the only binding portion of the lease has expired.

The four ways in which Frank Lyon Company can realize on its substantial investment all depend on an ownership interest in the building. These are:

(1) It can sell its interest at any time for what it can get. Pet. Br. 44; App. 261-62; P.Ex. 51 at App. 687.

(2) After the basic twenty-five year lease has expired, it may receive rent for the several renewal terms, if Worthen chooses to renew. But there is no guaranty that the renewal options will be exercised, either at the end of twenty-five years or at the end of any one or more of the renewal periods. Pet. Br. 29-33, 39-41.

(3) It may recover its investment with interest, if the purchase option is exercised. But the district court found, on evidence, that "it is most unlikely and improbable that Worthen will exercise its option to purchase at the end of the first eleven years of the lease or at the end of any of the subsequent option periods." Pet. App. 6a.

(4) If the options are not exercised and the lease is not renewed at any point—and Lyon can in no way require exercise of the options or renewal of the lease—then Lyon will continue to own the building and can realize on it what it can, by operation or sale.

To these should be added the ownership of the building during the eventual ten-year period after all extensions of the lease have expired. During this period, Frank Lyon Co. will—if it has not sold the building—own it outright with all of the benefits and burdens of ownership. At the close of the ten-year period, Frank Lyon Co. will still own the building, and will be entitled to equitable adjustment when the ground lease expires.

Thus, clearly Lyon has an ownership interest in the building. It must look to the continuing value of the property to protect its investment and to realize a return. It has no claim against Worthen after the initial

rental period has expired. Its protection is in its ownership interest in the building itself.

III

The circumstances in the *Sun Oil* case were not such that the parties were subjected to any unforeseeable or imponderable future contingencies. The option rights, "rejectable offer" provisions, and the "extraordinary" provision (Supp. Mem. App. 17a) which allowed Sunray to substitute land of equal book value to Sunray made it clear that Sunray was building up an equity in the properties. It could terminate the arrangement with the trust, and its obligation to pay rent, and take back the properties at any time within its own discretion, with only a small additional payment.[3] The court concluded that "the rights of substitution rendered illusory the lessor's rights to reject an offer." Supp. Mem. App. 18a.

As in the bank cases, discussed in Pet. Reply Br. at 9-11,[4] the unvarying history of the arrangement bore out the inference that Sunray *would inevitably reassume full ownership* and could do so *at any time*. The

[3] Similarly, the indifference of the trust to value apart from Sunray's repayment obligations is shown in the substitution provision. Equal book value has, of course, no relation to equal market value, but book value was the standard of exchange. Sunray could have exchanged a parcel with a market value of $1,000 for land worth $100,000 if the book value of the two parcels were the same. While this could undoubtedly have been a substantial financing convenience to Sunray, it is inconsistent with equity ownership by the trust.

[4] American National Bank of Austin v. United States, 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819; Union Planters National Bank of Memphis v. United States, 426 F.2d 115, 117-18 (6th Cir. 1970), cert. denied, 400 U.S. 827.

court noted that it was extremely unlikely that the trust would take possession or control. Supp. Mem. App. 19a.[5] Either rent or purchase would retire the "loan" at the agreed interest rate. The asset itself would go to Sunray and, being "mostly unimproved" land, was essentially not subject to either depreciation or casualty.

Decreasing option prices and rentals for land, which does not depreciate, may well reflect increasing equity in the lessee, and no risk of loss for the lessor. The *Sun Oil* court emphasized the fact that inflation in the value of the land was the probable expectation but that the options and rentals showed the opposite trend. Supp. Mem. App. 23a. However, a pattern of decreasing option prices and rentals with regard to a depreciating asset, such as the Worthen building, is quite consistent with the decreasing value of the asset to the lessor; and the district court accordingly found that the rentals and option prices were reasonable. Pet. App. 6a.

Finally, although Sunray and the trust were not related parties, the fact that the trust which provided the funds was tax-exempt introduces an element which is absent from the transaction here, which involves two fully taxable commercial taxpayers. This brings into play a number of tax considerations which do not affect the Lyon situation. See Pet. Br. 17, and n.18.

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[5] This conclusion is supported by ¶ 12 of the Sunray lease which provided that Sunray retained all rights to present and future improvements. At the end of Worthen's lease, however, all improvements go to Lyon. See Pet. Br. 40; P. Ex. 19, section 8.1 at App. 382-383.

IV

The Third Circuit did not ignore or overturn basic findings of fact made below as the court below did here. Rather, the *Sun Oil* court has in effect distinguished *Lyon* and cases like it by emphasizing the fact that the rentals there were not related to the value of the property. Supp. Mem. App. 27a-28a. The court relied on (1) specific testimony offered by the Government's expert witness, and (2) the Tax Court's failure to make any findings of fact or conclusions of law concerning the reasonableness of primary or extended term rentals. Supp. Mem. App. 21a, n.9. To illustrate the contrast, the *Sun Oil* court cited *Leslie Co.* v. *Commissioner*, 539 F.2d 943 (3rd Cir. 1976), where the Tax Court had made findings on the reasonableness of the rents and the Third Circuit relied on the findings of the Tax Court. Supp. Mem. App. 21a.

In the case at bar, the district court expressly found that the rentals were reasonable. Pet. App. 6a. Moreover, the Government offered no evidence as to the value of the properties, or the reasonableness of the rentals; the only expert testimony was offered by Frank Lyon Company, and the testimony fully supported the district court's findings as to the reasonableness of the rents and option prices. See Pet. Br. 28-30, 48; Pet. Reply Br. 8-9, n.2, 18-24. At the trial here, the Government did not even contest this point, and the findings of the trier of fact went against it.

Since there were no such findings in the *Sun Oil* case, the Third Circuit was not in the position of overturning or disregarding crucial findings of the trial court in order to reach its conclusion.

V

In order to determine tax substance, the *Sun Oil* court compared the situation there to the "traditionally bargained for business relationships between owner and lessee." Supp. Mem. App. 13a. Whatever those relationships may have been in the *Sun Oil* case, it is clear that here the relationships between owner and lessee were "traditionally bargained for" in long negotiations, which left Lyon, the owner, with substantial risks of ownership. It is also clear that the incidence of depreciation and interest deductions were an important element in that bargaining. If Lyon had had any reason to know that it could not deduct interest and depreciation, it would necessarily have sought and obtained a larger rental. There was not here any effort to deduct the cost of nondepreciable land through rental payments, as in *Sun Oil*. The only property here was a building, fully depreciable; and both of the parties here were fully subject to the provisions of the income tax law. There was no bargaining of the tax exemption here, as in *Sun Oil*.[6] Parties to such a bonafide transaction as that involved here should be able to count on the arrangement as they have set it up and should not be left to the uncertainties of the eventual decision of the ultimate appellate court.

It is far more sound to relate the essence of the bargain directly to the applicable provisions of the tax law and their purposes. Thus in the case before the court, the tax independent considerations which moti-

[6] Another relevant factual distinction between *Lyon* and *Sun Oil* is the lease option provision in *Sun Oil* which was drafted to insure that the parties could unwind the transaction if the tax benefits they sought were not achieved. Supp. Mem. App. 17a.

vated and formed the transaction,[7] the fair values of the option prices and rentals, the unlikelihood that the options to buy would be exercised, and the very real risks and burdens of depreciation borne by Lyon, support its claim to depreciation deductions. (There would appear to be no conceivable basis on which its interest deductions can be disallowed, for it paid interest which it owed.) No similar considerations appeared in the *Sun Oil* case to support the taxpayer's contention that the rents involved there were an ordinary and necessary business expense.

Respectfully submitted,

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October, 1977

[7] This included the fact that Worthen here was precluded by applicable law and regulations from owning the building. See Pet. Br. 44-46; Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972). There was no factor of this sort in the *Sun Oil* case, where all of the elements, without exception, pointed to a purely financial arrangement.